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No. 286

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SOUTHWEST CONSOLIDATED CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 31–45) is unpublished. The opinion of the Circuit Court of Appeals (R. 63–67) is reported in 119 F. (2d) 561.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 19, 1941 (R. 67). The petition for a writ of certiorari was filed July 19, 1941, and was granted on October 13, 1941. The jurisdiction of this Court rests on Section 240 (a) of the Ju-

dicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Pursuant to plan, corporate assets were bought in by a bondholders' committee at equity foreclosure and receivership sales. The property was transferred to the taxpayer, a new corporation, in exchange for stock which was distributed to participating creditors, and for stock purchase warrants which were distributed in part to creditors and in part to former stockholders. The question is whether the basis for computing gain or loss upon the subsequent disposition, etc., of the assets by the new corporation is the same as it would be in the hands of the old corporation under Section 113 (a) (7) of the Revenue Act of 1934. The answer depends upon whether the acquisition of the assets by the new corporation constituted a "reorganization" within Section 112 (g) (1).

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*, pp. 31–40.

STATEMENT

Southwest Gas Utilities Corporation, the taxpayer's predecessor corporation (hereafter referred to as Utilities) had outstanding in 1932, $2,871,500 face amount of 6½% First Lien and Secured Sinking Fund Gold Bonds, together with unsecured claims, preferred stock, and common

stock. Upon default in the interest payment on the bonds due May 1, 1932, a bondholders' committee was formed, which obtained the deposit of approximately 85% of the bonds. Members of the committee later became directors of Utilities and after October 7, 1932, were in control of the company (R. 31–32).

The following year, receivers were appointed by the Delaware Chancery Court in a consent proceeding (R. 32). In March 1934 a plan was proposed. The plan provided for the formation of a new company, which would acquire the assets of Utilities in exchange for its common stock and its Class A and Class B stock purchase warrants.[1] The common stock would be issued pro rata to the old bondholders, except for a small portion which, together with the Class A warrants, would be issued to unsecured creditors. The Class B warrants would be issued to the preferred and common stockholders (R. 33–34).

On May 11, 1934, the chancellor issued a decree approving the plan. Thereupon, pursuant to the plan and to court order, the assets pledged as security for the bonds were sold by the indenture trustee at foreclosure sale on June 25, 1934, and were bid in by the bondholders' committee for $660,000. The unpledged assets were sold at public auction on June 18, 1934, and were bought by

[1] The Class B warrants provided a higher purchase price, but both classes expired in 1938 (R. 33).

the committee for $92,000 (R. 34). The fair market value of the assets at this time was $1,766,694.98 (R. 38).

The taxpayer was formed on June 27, 1934; thereafter the committee transferred Utilities' assets to it, and the stock and warrants were distributed pursuant to the plan, as follows (R. 31, 36):

	Utilities	Taxpayer		
		Securities Issued		
	Amount Participating	Common Stock	A Warrants	B Warrants
Bonds	$2,450,500.00	49,010 shares		
Notes	107,000.00	214 shares	2,140	
Other Unsecured Claims	31,945.42	62 shares	620	
Preferred Stock	17,297 shares			17,297
Common Stock	57,470 shares			1,148¾₀

Non-participating holders of $421,000 of bonds and $19,000 of notes received a pro rata distribution of $106,684.06 in cash (R. 37).

The cost basis in the hands of Utilities of the assets acquired by the taxpayer had been $8,995,724.91 (R. 38). The taxpayer used this basis in computing gains and losses on the acquired assets (e. g., in computing deductions for worthless securities and bad debts, R. 39) in its income and excess-profits tax returns for the period June 27, 1934, to December 31, 1934, and for the calendar year 1935. The Commissioner, in determining deficiencies, used as the basis the cost of the assets to the committee, taking, as representing the cost,

the aggregate of $752,000 paid for them at the foreclosure and receivership sales (R. 38–40).

The Board of Tax Appeals, rejecting the Commissioner's position, decided that there was no deficiency for either year. (R. 46.) The court below affirmed.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the taxpayer's assets had been acquired in connection with a "reorganization" of Utilities and that therefore their basis was the cost to that company.

(2) In failing to hold that the basis of the assets was their cost to the bondholders' committee at the foreclosure and receivership sales.

(3) In sustaining the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

The effect of the readjustment was to liquidate the stockholders' investment in the enterprise and to transfer the ownership of the company to the participating creditors. In these circumstances, there is no practical justification for permitting the new company to continue to use the old basis. That basis reflected the investment cost of the properties while indirectly owned by the old stockholders, but it bears no relationship to the cost of the properties to the new owners. Consequently, the result of the taxpayer's position is an obvious tax windfall.

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The Government's position is that a new basis should be employed measured by the cost of the assets to the creditors when they take over the properties. This provides a sound basis for computing the tax and at the same time is fair to the creditors since depreciation in the value of their individual investments would be reflected in a capital loss upon exchange of their claim for the new stock.

Considered against this background, the rule of *LeTulle* v. *Scofield*, 308 U. S. 415, is clearly applicable. That case establishes the rule that where the stockholders of a corporation retain only a creditor position in a transferee corporation, there is lacking the continuity of proprietary interest required for a reorganization within the purview of the statute. Although that case involved a transfer of equity interests for a creditor's position, rather than the converse presented here, the underlying considerations are the same. The situation is not altered by the existence of the warrants, since they do not create a proprietary interest but merely confer a right to reinvest in the enterprise upon a new cash payment.

Furthermore, this transaction does not qualify as a reorganization or a tax free exchange even within the literal language of the reorganization definitions or of Section 112 (b) (5). Nor does the fact that the corporation was insolvent mean either that the creditors were the equivalent of the "corporation" or its "stockholders" before the fore-

closure sale, or that prior thereto they had a proprietary interest within the contemplation of *LeTulle* v. *Scofield, supra.* The identifiable event, legally effecting the shift in the character of their interests, was the foreclosure sale. Our conclusions are supported by the legislative purpose underlying the reorganization and nonrecognition provisions.

ARGUMENT

THE BASIS OF THE TAXPAYER'S ASSETS IS NOT THE SAME AS IN THE HANDS OF THE OLD CORPORATION

Introductory.—This case presents broadly the problem of the tax consequences of corporate readjustments in which creditors of the company become the stockholders of the new corporation which succeeds to the business of the old. The immediate issue is whether the new corporation is entitled to use the basis which the properties had in the hands of the old company in determining gain or loss upon the disposal of various of these assets.[2]

[2] The identical problem also arises in determining depreciation or depletion allowances, since the same basis is used for these purposes. Revenue Act of 1934, Section 114 (a). That is the immediate issue presented in the three companion cases: *Commissioner* v. *Bondholders Committee, Marlborough Investment Co.*, 118 F. (2d) 511 (C. C. A. 9th), and *Commissioner* v. *Palm Springs Holding Corp.*, 119 F. (2d) 846 (C. C. A. 9th), certiorari granted October 13, 1941, Nos. 128, 129, and 503, respectively; and *Commissioner* v. *Alabama Asphaltic Limestone Co.*, 119 F. (2d) 819 (C. C. A. 5th), certiorari granted October 13, 1941, No. 328. It is also

The readjustment was effected in accordance with the familiar practices employed in equity receivership proceedings. After the appointment of receivers in a consent state court proceeding, a bondholders' committee (which previously had

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presented in *Helvering* v. *New Haven & S. L. R. Co.*, 121 F. (2d) 985 (C. C. A. 2d), pending on the Government's petition for certiorari, No. 780, this Term. The other major question, which is correlative, is whether gain or loss will be recognized upon exchanges of the old securities for the new. That issue is presented in *Commissioner* v. *Cement Investors, Inc.*, 122 F. (2d) 380 (C. C. A. 10th), *Commissioner* v. *James Q. Newton Trust*, 122 F. (2d) 416 (C. C. A. 10th), and *Commissioner* v. *James Q. Newton, Jr.*, 122 F. (2d) 416 (C. C. A. 10th), now pending on petitions for certiorari, Nos. 644, 645, and 646 (this Term), respectively.

The problem is not limited to readjustments effected through receivership or foreclosure proceedings. The *Alabama Asphaltic* case, for example, involved a bankruptcy proceeding; the *Cement Investors* and *Newton* cases, a Section 77B proceeding.

Additions to the Bankruptcy Act of 1898 made by the Chandler Act (Act of June 22, 1938, c. 575, 52 Stat. 840), as further amended by the Act of July 1, 1940, c. 500, 54 Stat. 709, Section 1, now require with respect to proceedings under Section 77B or Chapter X that the basis of the debtor's property or the basis of property "transferred to any person required to use the debtor's basis in whole or in part shall be decreased to an amount equal to the amount by which the indebtedness of the debtor * * * has been canceled or reduced by a proceeding under this chapter, but the basis of any particular property shall not be decreased to an amount less than the fair market value of such property as of the date of entry of the order confirming the plan." Bankruptcy Act of 1898, as amended, Sections 270, 276c (3) (U. S. C. Supp. V, Title 11, Sections 670, 676). See Regulations 101, Article 113 (b)-2, and Regulations 103, Section 19.113 (b) (1)-2, as amended by T. D. 5003, 1940-2 Cum. Bull. 107; G. C. M. 22528, 1941-8 Int. Rev. Bull. 2. Similar

obtained deposits of approximately 85% of the bonds) promulgated a plan of reorganization. The substance of the plan was that the creditors would take over the ownership of the company through the medium of a new corporation. The stockholders would receive no participation in the new company except upon making a cash payment in exercise of stock purchase warrants to be distributed to them. In order to effect the plan, the Debtor's free assets were sold at receivership sale and the pledged assets, at foreclosure sale; in each instance, they were bid in by the committee. Presumably deposited bonds were applied in part payment, and nonassenting creditors received a pro rata cash distribution. Thereafter, the assets were transferred to the taxpayer, the new corporation, in exchange for stock which was distributed to participating creditors, and for stock purchase warrants which were distributed in part to creditors and in part to former stockholders.

The taxpayer's right to use the old basis of $8,995,724.91 is dependent upon its showing that it comes within one of the exceptions to the gen-

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provisions apply with respect to compositions under Sections 12 or 74 of the Bankruptcy Act (U. S. C., Title 11, Sections 30 and 202), arrangements under Chapter XI, and real property arrangements by persons other than corporations under Chapter XII. Act of June 22, 1938, Sections 396, 399 (4), 522, 526 (c) (U. S. C. Supp. V, Title 11, Sections 796, 799, 922, 926), as amended by the Act of July 1, 1940. See Regulations, *supra*.

eral rule that the basis of property should be its cost. Sections 113 (a) and 114 (a) of the Revenue Act of 1934 (Appendix, *infra*); Regulations 86, Articles 113 (a)–2 and 113 (b)–1 (Appendix, *infra*). Alternate claims are made: *first*, that the assets were acquired in a reorganization within the meaning of Section 112 (g) (1) of the Revenue Act of 1934 (Appendix, *infra*) and that therefore the old basis should be used under Section 113 (a) (7) of the Act; and, *secondly*, that the assets were acquired in connection with a transaction described in Section 112 (b) (5) and that therefore Section 113 (a) (8) is applicable.

There has been uncertainty as to the applicability of the reorganization provisions to situations of this type, and in the past the Commissioner has taken the position in each case that was necessary to protect the revenues. See *e. g., Commissioner* v. *Kitselman*, 89 F. (2d) 458 (C. C. A. 7th), certiorari denied, 302 U. S. 709; *Commissioner* v. *Newberry L. & C. Co.*, 94 F. (2d) 447 (C. C. A. 6th).[2]

[2] The *Newberry* case raised a basis question; the *Kitselman* case, a question of recognition of loss upon exchange of the creditors' claims for stock of the new company. The Commissioner contended that there was not a reorganization in the *Newberry* case and that there was in the *Kitselman* case. The Board of Tax Appeals in both cases had held that there was no reorganization. *Newberry* v. *Commissioner*, 33 B. T. A. 150; *Kitselman* v. *Commissioner*, 33 B. T. A. 494. Contrary decisions previously had been reached in similar situations (*First National Bank of Champlain, N. Y.* v. *Commissioner*, 21 B. T. A. 415; *Rockford Dairy, Inc.*, v. *Commissioner*, 26 B. T. A. 501), but the Board,

That uncertainty was attributable in part to the doubts raised by *Helvering* v. *Watts*, 296 U. S. 387, as to the status of bondholders in corporate reorganizations. But that uncertainty has since been largely dispelled by *LeTulle* v. *Scofield*, 308 U. S. 415, which established the basic principle that a continuity of proprietary interest is necessary to a reorganization for income tax purposes, and that a creditor position is not such an interest. Accord: *Helvering* v. *Tyng*, 308 U. S. 527, reversing *Commissioner* v. *Tyng*, 106 F. (2d) 55 (C. C. A. 2d), rehearing denied, 309 U. S. 694. Accordingly upon reexamination of the problem in the light of these decisions, it is the Government's position that readjustments of the type presented here are not properly within the reorganization provisions. As we shall endeavor to show, the claims to an exception advanced by the taxpayer do not meet the test laid down in the *LeTulle* case, they are not supported by the language of the statute, and they run counter to the underlying legislative intent.

A. *Practical Aspects of Problem*

The legal questions should be considered against the background of the practical tax aspects of the

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in the *Kitselman* case, refused to follow its earlier holdings, stating that to the extent they were in conflict with the requirement of a continuity of interest laid down in *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462, and *Cortland Specialty Co.* v. *Commissioner*, 60 F. (2d) 937 (C. C. A. 2d), certiorari denied, 288 U. S. 599, they were no longer authoritative. The two Circuit Courts of Appeal, however, held that there was a reorganization.

problem. As the facts of the instant case emphasize, there is no equitable or business justification for permitting the owners of the new company to continue to use the old basis.

Where a corporate transaction results in a continuation of an existing investment merely in a different form, it is understandable that the owners of that investment should be permitted to retain the same basis for tax purposes. Regulations 86, Article 112 (g)-1. (Appendix, *infra.*) That basis continues to reflect the investment cost of the properties still indirectly owned by the same persons. Cf. *Prairie Oil & Gas Co.* v. *Motter*, 66 F. (2d) 309, 312 (C. C. A. 10th). Accordingly, if the stockholders' interests in the old company had been continued in the taxpayer, sound support for the use of the old basis of approximately $9,000,000 would appear.

This readjustment, however, liquidated the investment of the stockholders. The warrants, distributed to those stockholders who bothered to take them,* provided only a privilege to buy into the new enterprise upon a new cash payment. The result was a clean break in the ownership of the company, with the participating creditors now taking over the equity interest.

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* The record shows (p. 36) that of the 171,915 shares of common stock outstanding, only 57,470 shares participated in the plan; of 32,244 shares of preferred stock outstanding, only 17,297 shares participated. In other words, holders of about two-thirds of the common stock and one-half of the preferred stock did not make the exchange.

Plainly the old basis bears no relationship to the cost of the properties to these new owners. They acquired the assets at the judicial sale in substance by paying for them with their claims of approximately $2,500,000 face amount, which were worth no more than $1,766,694.98, the total market value of the underlying properties. Yet, if the taxpayer is sustained, its gains or losses for tax purposes will be measured on the assumption of an investment of approximately $8,900,000. In comparable situations, depreciation or depletion would be computed on a similarly inflated basis. This means an obvious tax windfall.

In contrast, the Government's position reaches a result that is sound and fair. A new cost basis is adopted for the taxpayer measured by what the creditors pay when they become the owners.[5] As a

[5] The Commissioner previously has contended that the cost should be measured by the bid price. The regulations, applicable to mortgage foreclosure situations generally, however, provide that if a "creditor buys in mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property * * * and the fair market value of the property"; and that the basis for determining gain or loss in the event of resale "is the fair market value of the property at the date of acquisition." Regulations 86, Article 23 (k)–3. *Commissioner* v. *West Production Co.*, 121 F. (2d) 9 (C. C. A. 5th), certiorari denied, November 10, 1941. In *Commissioner* v. *New President Corporation*, 122 F. (2d) 92, the Circuit Court of Appeals for the Eighth Circuit, while agreeing with the Government that there was no reorganization in a receivership case such as the instant pro-

corollary, gain or loss will be recognized upon the exchange of the claims for stock of the new company since Section 112 (b) (3) will be inapplicable.[6] Thus, measured by the basis of the various claims to the individual creditors (ordinarily, of course, the cost), each creditor will be entitled to a capital loss which will reflect the depreciation in the value of his original investment.[7] Consequently, an adjustment is made on an individual basis which takes into account both the fact that the new basis will be less than the full amount of the existing claims, and that sales or other transfers of the claims probably have taken place since their original creation.[8]

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ceeding, held that this regulation governed in determining the basis for measuring gain upon sale of the property acquired by the new corporation. The Government has not sought review of this decision.

Accordingly, it is now our position that the bid price is only presumptively the cost of the property to the committee, and that the presumption may be rebutted by appropriate evidence.

[6] Section 112 (b) (3) of the Revenue Act of 1934 provides:

"(3) STOCK FOR STOCK ON REORGANIZATION.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

[7] By the same token, gain will be recognized to the extent that any creditor may have purchased the claims at depressed prices and has actually realized a gain upon the exchange for the new stock. See fn. 2, *supra*.

[8] Due to the limitations which the statutes place upon capital losses (*e. g.*, Revenue Act of 1934, Sections 117 (a)

B. *Absence of Continuity of Proprietary Interest*

In the light of these practical considerations, the applicability to this situation of the test of a reorganization, established by this Court in *LeTulle* v. *Scofield, supra,* seems clear. That decision establishes the rule that there is no reorganization within the purview of the statute where the owners of a transferor corporation receive in exchange only a creditor position in the transferee corporation. Even though long term bonds are retained, this is not sufficient to establish the necessary continuity of proprietary interest. If that continuity is lacking, the transaction is not a reorganization, even though it may otherwise be fitted into the literal language of the statutory definition. Regulations 86, Article 112 (g)–1.[9] In the instant case, where the transfer shifted the ownership of the equity in the properties from the stockholders to the creditors of the old corporation, the continuity was definitely broken.

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and (d)), the adjustment may not be complete in every case. This is a circumstance, however, which may exist whenever property is sold or exchanged at a loss.

[9] It seems clear that the same rule governs in determining the application of the non-recognition provisions of Section 112 (b) (5). The underlying assumptions of these provisions and the reorganization definition are essentially the same. See *American Compress & Warehouse Co.* v. *Bender*, 70 F. (2d) 655, 657–658 (C. C. A. 5th), certiorari denied, 293 U. S. 607; *Lloyd-Smith* v. *Commissioner*, 116 F. (2d) 642, 644 (C. C. A. 2d), certiorari denied, 313 U. S. 588; Regulations 86, Articles 112 (a)–1 and 112 (g)–1.

In the *LeTulle* case, corporate assets were transferred in exchange for cash and $750,000 in bonds of the acquiring corporation. These bonds were distributed to the stockholders of the transferor in exchange for the stock. The Court, holding that the transaction was not a reorganization and that therefore, the stockholders were taxable upon the gain which they realized, said (pp. 420–421):

> In applying our decision in the *Pinellas* case [*Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462] the courts have generally held that receipt of long term bonds as distinguished from short term notes constitutes the retention of an interest in the purchasing corporation. * * *
>
> We are of opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute.

> We conclude that the Circuit Court of Appeals was in error in holding that, as respects any of the property transferred to the Water Company, the transaction was other than a sale or exchange upon which gain or loss must be reckoned in accordance with the provisions of the revenue act dealing with the recognition of gain or loss upon a sale or exchange.

On its facts, the *LeTulle* case involves the converse of the situation now before the Court. There, the stockholders of the transferring corporation surrendered their equity interest and retained a creditor position. Here, the creditors of the transferring corporation surrendered their claims and acquired an equity interest in the new company. The significant fact, however, is that here as in the *LeTulle* case the ownership interest in the transferee company was not retained by the holders of the ownership interest in the transferor. Under the plan, the equity interest of the old stockholders was eliminated. No more than in the *LeTulle* case was the situation one in which an existing proprietary interest was substantially continued under a new corporate form.

This conclusion is not affected by the issuance of the warrants to the former stockholders. The court below properly recognized that their existence was immaterial. Even if we should assume these warrants had a value, as the taxpayer insists, this does not mean that they created a

proprietary interest.[10] The warrants merely gave the old stockholders a right to reinvest in the company at the prices prescribed. That right was even farther removed from a proprietary interest than the rights under the bonds retained by the old stockholders in the *LeTulle* case. Indeed, the fact that the warrants did not create any interest in the new corporation follows *a fortiori* from *Helvering* v. *Tyng, supra.* In that case, the lower court had held that creditor instruments, which were convertible into stock at the option of the owner, provided a continuity of interest. *Commissioner* v. *Tyng,* 106 F. (2d) 55 (C. C. A. 2d). On the authority of *LeTulle* v. *Scofield, supra,* this Court reversed the judgment below *per curiam* (308 U. S. 527) and denied petitions for rehearing based on the specific contention that the convertible feature distinguished these securities. 309 U. S. 694.

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[10] The preferred stockholders had received one class B warrant for each share held and the common stockholders, one Class B warrant for each fifty shares held. These warrants were priced at $10 a share during 1934 and at an increase of $5 each year until expiration in 1938. (R. 33, 34.) As stated above (fn. 4) about two-thirds of the common and one-half of the preferred stock did not make the exchange. Of the warrants actually issued, approximately 75% were allowed to lapse (R. 38).

As against 49,286 shares of the stock of the taxpayer issued to the creditors in exchange for their claims, only 4,623 were issued upon exercise of the Class B warrants issued to the stockholders. An additional 1,760 shares were issued upon exercise of the Class A warrants issued to creditors (R. 35–36, 38).

C. *The Literal Language of the Statute*

Our primary contention, as thus developed, is that this transaction is beyond the purview of the statute because the proprietary interest in the old corporation is not continued in the new. Under the rules laid down in the decided cases, this conclusion would not be altered even though the transaction might otherwise be fitted into the literal language of the statutory provisions. E. g., *LeTulle* v. *Scofield, supra; Pinellas Ice Co.* v. *Commissioner, supra.* In the instant case, however, the taxpayer's claim to the benefit of these special exceptions falls for the further reason that the transaction does not comply with the detailed requirements laid down in the act.

In considering this point, there are two possible analyses of the transaction. On the one hand, emphasis may be placed upon the legal machinery employed. Thus, the transaction would be treated as involving two separate steps: (1) the purchase of the assets by the committee from the receivers and the indenture trustee for the amount of the bid prices; and (2) the committee's transfer of the assets to the new corporation, in return for a distribution of its stock and the stock purchase warrants as the plan provided. On the other hand, the separate steps of the transaction may be disregarded and emphasis placed upon the ultimate result. Thus, the transaction would be regarded simply as a transfer of the old corporation's assets to the new corporation; in return the new corporation would distribute its

securities in accordance with the plan and provide the cash required to pay off dissenters.

1. If the transaction is analyzed as involving two separate steps, it is plain that the statute would not permit the new corporation to use the basis of the old. The first step, the acquisition of the assets by the committee, involved neither an intercorporate transaction, which might conceivably be a reorganization under any of the definitions of Section 112 (g) (1), nor a transfer to a corporation, which might conceivably be said to bring it under Section 112 (b) (5). In the absence of any provision entitling the committee to the old corporation's basis, it follows that the basis to the committee must be their cost.[11] The second step in the transaction, however—the committee's transfer of the assets to the new corporation—would be tax free under Section 112 (b) (5); consequently, the committee's basis carries over to the taxpayer under Section 113 (a) (8).

This is the precise result for which we contend. In this connection, it should be emphasized that these two steps accurately reflect the actual substance of the plan, as it was contemplated that it should be carried out and as in fact it was carried out. The assets were bought in at the sales in behalf of the participants under the plan. The consideration paid the receivers and indenture

[11] Cost would be measured, according to our present position, by the market value of the assets acquired. Fn. 5, *supra*.

trustee for their transfers consisted of the bid price, presumably represented in part by cash and in part by the surrender of deposited bonds. This transaction foreclosed any interests of the former stockholders, and at the same time enabled the assentors to buy out the interests of nonassentors. The second step in the transaction served simply to substitute the new corporation in the place of the committee. In thus succeeding to the committee's interests in the assets it had purchased, the taxpayer was properly entitled to use the committee's basis, namely, the committee's cost. But this fact provides no warrant under the statute, for saying further that the taxpayer, either directly or through the committee, was entitled to use the higher basis in the hands of the old corporation.

2. Even if the plan is analyzed, however, with the emphasis placed upon the ultimate result rather than upon the action taken, the transaction does not qualify as a reorganization or a tax-free transfer entitling the taxpayer to the use of the old basis.

Clause B of Section 112 (g) (1) would not be applicable since it requires that the acquisition by the transferee corporation be *solely* in exchange for voting stock. Here, by hypothesis, cash for dissenters and the stock purchase warrants were also exchanged. The warrants were not stock and they did not confer any voting rights upon their holders; as we have already stated, the fact

that they could be converted into stock upon payment of the purchase price did not make them the same thing.[12]

Clause C requires that the transfer be by a "corporation" and that "after the transfer the transferor or its stockholders or both" be "in control of the" transferee. Even if we assume that the transfer was made by the old corporation, rather than by the receivers and the indenture trustee (but *cf. United States* v. *Galveston-Houston Electric Co.*, 84 F. (2d) 516 (C. C. A. 1st), certiorari denied, 299 U. S. 590), neither the old corporation nor its stockholders were thereafter in control of the new company. That control, as defined in Section 112 (h) requires the "ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation." After the transfer, control was not in the old company itself or in its stockholders but in the participating creditors. They received all of the taxpayer's stock (except for the small

[12] The taxpayer has referred to a contrary view expressed by the Commissioner in a letter to The Middle West Corporation, dated January 27, 1937. 1937 CCH Vol. 3, Par. 6118. This conclusion appears erroneous in light of this Court's subsequent determination in *Helvering* v. *Tyng*, *supra*. The letter is not controlling, moreover, since it was neither a formal ruling of the Treasury Department intended to have general application, nor did it represent a long-continued, uniform administrative construction.

fraction issued upon exercise of the warrants).[13] Upon no basis of calculation can it be concluded that 80% of the stock was owned by Utilities stockholders.[14]

For this same reason, the transaction would not fit the requirements of Section 112 (b) (5). The section similarly requires that control be continued in the "transferor." Whether we regard the old corporation, or the receivers and the indenture trustee as the "transferor," the control plainly passed to others.

Lastly, although the taxpayer has argued the contrary, it seems too clear for discussion that the transaction is neither a "recapitalization" under Clause D of the reorganization definition nor a "mere change in identity, form, or place of organization, however effected" under Clause E. The term "recapitalization" obviously refers to an internal readjustment of existing security interests within a corporation, and it may be assumed

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[13] See fn. 10, *supra*. The court below intimated that some weight should be attached to the circumstance that some of the creditors had also been stockholders, and the fact has been emphasized by the taxpayer. But stockholders of the old ucorporation, *qua* stockholders, received only stock-purchase warrants. None of the creditors participated in the new company by reason of their stock holdings. The circumstance that there was this duality is of no significance.

[14] If *all* the stockholders of Utilities had exchanged their stock for the warrants, and if *all* these warrants had been exercised, approximately 35,000 shares of the taxpayer's stock would have been issued to the old stockholders. This would be substantially less than 50% of the total.

that Clause E means no more than it says. It follows without elaboration that a transaction which shifts the entire ownership of an enterprise from its stockholders to a new corporation owned by a majority of its creditors is outside the scope of these provisions.

3. The taxpayer has introduced a third variation by the theory, advanced in the court below, that the bondholders had exchanged their bonds for stock of the new corporation; that this was a transaction described in Section 112 (b) (5); and that therefore the taxpayer had issued its securities "in connection" with such a transaction and was entitled to the basis of the "transferor" under Section 113 (a) (8). Cf. *Commissioner* v. *Cement Investors, Inc., supra.* It is unnecessary to consider in this case the question whether gain or loss would be recognized upon the bondholders' exchanges under Section 112 (b) (5). In the *Cement Investors* and *Newton* cases, which directly involve the issue, the Government contends that they are not. The decisive fact here is that the problem, so far as it affects the application of Section 113 (a) (8), would be relevant only if we were concerned with the basis of the bonds in the hands of a transferee. Even if Section 112 (b) (5) were applicable, in the manner suggested by the taxpayer, it would not follow that the basis of the assets of the taxpayer would be the same as in the hands of the old corporation.

D. *Immateriality of Debtor's Insolvency*

In seeking to avoid the application of the rule laid down in the *LeTulle* case, and as well as to bring this type of situation within the particular language of Clause C, the argument is made that where a corporation has become insolvent, the creditors have in substance become the owners of its property. This view was first adopted in *Commissioner* v. *Kitselman, supra,* and *Commissioner* v. *Newberry L. & C. Co., supra.* These cases, which were decided prior to *LeTulle* v. *Scofield, supra,* held that where properties were bought in by bondholders at equity foreclosure sales, there was a reorganization, although the stock interests were eliminated. Considerable weight was attached to these decisions both by the Board of Tax Appeals and the court below in reaching decisions adverse to the Government in the instant case.[15]

The theory of the *Kitselman* case (89 F. (2d) at p. 461), which the *Newberry* case apparently followed, is that in the event of insolvency (although prior to foreclosure) bondholders are "in actuality and for all practical purposes pretty much the corporation"; that they are "stepped up" to the position of stockholders; that they "supersede the stockholders" and "acquire the stockholders' rights to manage the corporate affairs." From these observations, it was concluded that the bond-

[15] This has likewise been true in the opinions in the companion cases. Fn. 2, *supra.*

holders must be viewed as a "class of 'stockholders' " of the old corporation.

It is true, of course, that under now well-settled principles of reorganization law, the creditors of an insolvent corporation will be entitled to all the assets of the corporation in any fair plan that is evolved. *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106; *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510. It by no means follows, however, that they have such ownership prior to the critical event (whether it be foreclosure or consummation of a plan) which results in their acquisition of the assets. Before that time, the stockholders continue to have certain well-defined rights. If the company is in receivership, they continue to elect the officers and directors of the company. The management may initiate other proceedings, as for example, filing a voluntary petition in bankruptcy or under Section 77B or Chapter X of the Bankruptcy Act. If, at the time of the sale, the value of the assets should turn out to be greater than the creditors' claims, the excess belongs to the stockholders.

For tax purposes, the anticipation of a proprietary interest is not its equivalent. This was brought out by this Court in the *LeTulle* case in its statement that merely because, upon default, "the bondholder would retake only the property sold," this does not change "his status from that of a creditor to one having a proprietary stake, within the purview of the statute." *LeTulle* v. *Scofield*,

308 U. S. 415, 421. The Court reemphasized the point in *Commissioner* v. *Tyng, supra,* by its determination that creditor obligations did not provide a continuity of proprietary interest even though they were convertible into stock at the option of the owner.

The decisions adverse to the Government's position do not deny that under the *LeTulle* case the transfer of a creditor's claim for an ownership interest would, in the absence of insolvency, be outside the application of the reorganization sections. Indeed, that this is so is emphasized in *Helvering* v. *New Haven & S. L. R. Co.,* 121 F. (2d) 985 (C. C. A. 2d).[16] The theory, however, is that in substance this shift has already taken place. Therefore, it is argued, the creditors are already the practical equivalent of owners of the enterprise, and consummation of the plan, by means of the foreclosure sale, provides no substantial change in the existing interests. *Ibid.*

This reasoning reveals the essential fallacy in these decisions from a tax standpoint. It concedes that there has been a shift in the nature of the investment of a character upon which gain or loss should be recognized; that is, a shift from a creditor to an ownership position. It treats that shift,

[16] "* * * there would be no 'reorganization' because the bondholders would receive a different interest in the property from what they had had before, and it was this circumstance, as we understand it, which was determinative in *LeTulle* v. *Scofield, supra* (308 U. S. 415)." *Ibid,* at p. 987.

however, as taking place at a time and in a manner which provides no identifiable incident that may be the taxable event. That incident, we submit, is properly to be found in this type of proceeding in the judicial sale. It is the sale which changes the legal rights (Cf. *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 225), and there is no reason to disregard it.

E. *The Legislative Intent*

Finally, our conclusions that the reorganization and non-recognition provisions are not applicable to readjustments which operate to turn over the corporation's assets to its creditors is required by the plain import of these provisions. These provisions show on their face that they were intended to apply to corporate readjustments in the course of going business operations which require merely the reissuance in another form of securities that evidence the participation of the owners of the enterprise. That is what normally happens in statutory consolidations or mergers, or in recapitalizations, or when there is a mere change in identity, form, or place of organization. None of the types of transactions included in these definitions contemplates the elimination of an ownership interest from participation in the corporate undertaking. On the contrary, they all definitely contemplate proceedings in which the stockholders will continue their participation in the ownership of the enterprise.

This is the legislative purpose which has been embodied expressly in the requirement of Clause C that "control" be continued in the old corporation or its stockholders, and in the requirement of Section 112 (b) (5) that the persons making the transfer continue in "control." It is the same legislative purpose which, we believe, underlies the decisions that have developed judicially the rule requiring a continuity of interest. *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462; *Helvering* v. *Minnesota Tea Co.,* 296 U. S. 378; *LeTulle* v. *Scofield, supra; Cortland Specialty Co.* v. *Commissioner,* 60 F. (2d) 937 (C. C. A. 2nd). For where corporate assets have been transferred in return only for a claim against the transferee, and the proprietary interest of the old stockholders has been eliminated, the transaction is not a continuance in another form, of the original investment but, like an outright sale, is a termination of the investment of the original owners.

Specific recognition of the principle, as expressed by the Court, was given in the Report of House Committee on Ways and Means on the Revenue Act of 1934. The report stated (H. Rep. No. 704, 73d Cong., 2d Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 554, 564)):

> The Supreme Court has indicated that the broad principle underlying these sections is that no taxable profit is realized from a reorganization, if no money passes and if the changes in corporate organization are

> essentially changes only in form, *with the stockholders continuing their former interest in the original enterprise.* [Italics supplied.]

The same general purpose and principle are expressed in the applicable Treasury Regulations. Regulations 86, Article 112 (g)–1.

Determination of the instant case in the light of this underlying principle requires a decision in accordance with our position. The ultimate effect of the plan was to transfer the debtor's assets to assenting creditors in satisfaction of their claims. Cf. *Case* v. *Los Angeles Lumber Co., supra,* at pp. 119–120. In exchange, they acquired all the advantages and benefits of equity ownership—the management and control of the properties and the right to all available earnings and appreciation in value. The stockholders, the prior owners of the property, no longer had any interest in it, simply retaining an option to buy back a partial interest in the company according to the terms of the warrants. Such transactions are entirely comparable to the sale transactions with respect to which the continuity of interest rule has been established. *Pinellas Ice Co.* v. *Commissioner, supra; LeTulle* v. *Scofield, supra.*

CONCLUSION

The judgment of the court below should be reversed with directions that upon remand to the Board of Tax Appeals the deficiency be recom-

puted using as the basis the stipulated market value of the assets acquired.

Respectfully submitted.

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DECEMBER 1941.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(U. S. C., Title 26, Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in pro-

portion to his interest in the property prior to the exchange.

* * * * *

(g) *Definition of Reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however effected.

* * * * *

(h) *Definition of Control.*—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

* * * * *

(U. S. C., Title 26, Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(7) *Transfers to Corporation where Control of Property Remains in Same Persons.*—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

(8) *Property acquired by Issuance of Stock or as Paid-in Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the

amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * * *

(U. S. C., Title 26, Sec. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

(b) *Basis for Depletion.*—

(1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * * *

(U. S. C., Title 26, Sec. 114.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 112 (a)–1. *Sales or exchanges.*—The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112.

The general rule is that the entire amount of such gain or loss is to be recognized.

An exception to the general rule is made by section 112 (b) in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Act provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

* * * * *

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Act only if the exchange is one which satisfies both (1) the specific description in the Act of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be

shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

To constitute an exchange within the meaning of section 112 (b) the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

* * * * *

ART. 112 (g)-1. *Purpose and scope of exception of reorganization exchanges.—Purpose:* Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Act is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Act, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Act are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Act recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Act recognizes as a reorganization the amalgamation (occurring in a specified

way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Act, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

* * * * *

ART. 112 (g)-2. *Definition of terms.*— The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112 (g) (1). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange.

* * * * *

In order to qualify as a "reorganization" under section 112 (g) (1) (B), the aquisi-

tion by the acquiring corporation of the required amount of the stock, or of substantially all the properties, of the other corporation must be in exchange *solely* for all or a part of the *voting stock* of the acquiring corporation. If, for example, Corporation X exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the aquisition of the required amount of stock, or of the properties, of Corporation Y, the transaction is not a "reorganization" exchange, and the gain or loss therefrom will be recognized.

A "recapitalization," and therefore a reorganization, takes place if, for example

(1) A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders, par for par;

(2) There is surrendered to a corporation for cancellation 25 per cent of its preferred stock in exchange for no par value common stock;

(3) A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or

(4) An exchange is made of a corporation's outstanding preferred stock, having certain priorities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights.

* * * * *

The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition

of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges as are directly a part of the transaction specifically described as a reorganization in that subsection. Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112 (g) (1), but the readjustments involved in the exchanges effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

* * * * * *

ART. 113 (a)-1. *Scope of basis for determining gain or loss.*—The basis of property for the purpose of determining gain or loss from the sale or other disposition thereof is the unadjusted basis prescribed in section 113 (a), adjusted for the various applicable items specified in section 113 (b). Unless otherwise indicated, the word "basis," as used in this article and articles 113 (a)-2 to 113 (a) (14)-1, inclusive, has reference to the unadjusted basis.

ART. 113 (a)-2. *General rule.*—In general, the basis of property is the cost thereof. This rule is subject, however, to the exceptions stated in paragraphs (1) to (14) of section 113 (a).

* * * * * *

ART. 113 (b)-1. *Adjusted basis: General rule.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, is the cost of such

property or, in the case of such property as is described in paragraphs (1) to (14), inclusive, of section 113 (a), the basis therein provided, adjusted to the extent provided in section 113 (b).

* * * * * *

ART. 114–1. *Basis for allowance of depreciation and depletion.*—The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, except as provided in article 23 (m)–3, relating to depletion based on discovery value, in article 23 (m)–4, relating to percentage depletion in the case of oil and gas wells, and in article 23 (m)–5, relating to percentage depletion in the case of coal mines, metal mines, and sulphur mines or deposits.

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